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In the

Supreme Court of the United States

OCTOBER TERM 1964

No. 899

MURPHY OIL CORPORATION,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Eighth Circuit, entered in the above-entitled case on October 28, 1964, (rehearing denied November 17, 1964).

CITATIONS TO OPINIONS BELOW

The opinion of the District Court (R. 24), printed in Appendix A, hereto, *infra*, p. A-1, is reported in 230 F. Supp. 583. The opinion of the Circuit Court of Appeals, printed

in Appendix B hereto, *infra*, p. B-1, is reported in 337 F. 2d 677.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on October 28, 1964, (C.R. 4).* Rehearing was denied on November 17, 1964, (C.R. 8). The jurisdiction of this Court is invoked under 28 U.S.C., Section 1245 (1).

QUESTIONS PRESENTED FOR REVIEW

Whether a cash bonus paid by the taxpayer in connection with the execution of an oil and gas lease is to be excluded from gross income in determining taxable income.

In the alternative, if the cash bonus is not to be excluded from gross income in determining taxable income, whether such bonus similarly is not to be excluded from gross income in determining statutory depletion.

In any event, whether a cash bonus should not be excluded from gross income in determining statutory depletion when the lessor is a Governmental Agency.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the Internal Revenue Code of 1939 and Treasury Regulations are set forth in Appendix C, *infra*, p. C-1. They are as follows: Sections 23(m) and 114(b)(3) of the Internal Revenue Code of 1939, and

* Supplemental Proceedings in the United States Court of Appeals for the Eighth Circuit as annexed to the Certified Record.

Sections 39.23(m)-1(e)(5) and 39.23(m)-10(e) of Treasury Regulations 118.

STATEMENT

1. *Preliminary*

This case presents the issue of the proper treatment for Federal income tax purposes of a cash bonus paid by the lessee in connection with the execution of an oil and gas lease.

We deal here with fundamental tax concepts which have remained the same since the passage of the 16th Amendment and the first income tax act. Tax is levied upon "taxable income." To arrive at "taxable income", we have historically utilized concepts of "gross receipts", "exclusions", "gross income" and "deductions." From "gross receipts" there are items that are "excluded" in arriving at "gross income." From "gross income" there are items which are "deducted" in arriving at "taxable income."

In the setting of receipts from oil and gas production, with which this case is concerned, a simple illustration demonstrates these principles. Assume the typical situation of a lessee acquiring a 7/8ths working interest and the lessor retaining a 1/8th royalty interest. If gross production is $80,000, the lessor is entitled to $10,000. Since a royalty interest is an item of "exclusion" for the lessee, he reports "gross income" attributable to his interest of $70,000, and thus "excludes" the $10,000 royalty. The lessee would have expenses in producing the oil which he then "deducts" in arriving at his "taxable income."

One of the lessee's deductions from "gross income" is the deduction for statutory depletion. Section 114(b)(3) of the 1939 Code, Appendix C, *infra* at C-2 provides that the amount of such deduction is 27½% " of the *gross income* from the property * * * *excluding* * * * royalties . * * *" [Emphasis added.] In the above illustration the lessee's gross income for depletion purposes is the same as his gross income for taxation purposes—$70,000. He excludes the royalty in both instances for exactly the same reason—it is income attributable to the interest of another and hence, though part of his "gross receipts", it is not part of his "gross income."

The same rules apply to an advance royalty—it is excluded from the lessee's taxable "gross income" and depletable "gross income." The question in this case concerns these fundamental precepts as applied to a cash bonus which, as this Court has held, is an advance royalty to the lessor.

2. *The Facts in the Case at Bar*

Petitioner instituted this suit in the District Court after its claim for refund had been rejected by the Internal Revenue Service. The facts are not in dispute and may be summarized as follows:

Petitioner is engaged in the exploration, drilling and production of oil and gas properties and has its principal place of business in El Dorado, Arkansas. In 1951, the Department of the Interior offered for oil and gas leasing a portion

of Government land on the Barksdale Air Force Base located in Bossier Parish, Louisiana. The announcement stated that leases would be sold on a cash-bonus basis by sealed bids at stipulated rental and royalty rates. Petitioner (through an agent) and another corporation jointly submitted three separate bids for oil and gas leases on the three tracts covered by the Department of the Interior's leasing announcement. These bids were accepted and a cash bonus in the total amount of $4,547,000 was paid to the United States. Petitioner paid 50%, $2,273,500, of the total cash bonus.

Exploration for oil and gas on these leases was successful and for its fiscal year ended May 31, 1953, Petitioner had gross income from oil and gas sales attributable to its interest of $1,056,799.46 after exclusion of $181,880 which was the aliquot portion of the cash bonus which Petitioner had paid to the United States. Statutory depletion rather than cost depletion was applicable to Petitioner's income from such leases for this fiscal year.

In computing Petitioner's tax liability for the fiscal year ended May 31, 1953, the Internal Revenue Service refused to exclude the $181,880 aliquot portion of the cash bonus from Petitioner's "gross income" but inconsistently excluded such amount from Petitioner's "gross income" from these leases for purposes of computing Petitioner's statutory depletion allowance.

The lower Courts have sustained the Government's treatment of the cash bonus paid by Petitioner to the United States.

REASONS FOR GRANTING THE WRIT

1. The decisions below are in conflict with the decision of the Fifth Circuit in *Lambert v. Jefferson Lake Sulphur Company*, 236 F. 2d 542 (1956), where it was held that payments essentially equivalent to an installment bonus were excludable by a lessee from taxable gross income. The decisions below also conflict in principle with the decisions of this Court in *Burnet v. Harmel*, 287 U.S. 103 (1932), *Anderson v. Helvering*, 310 U.S. 404 (1940) and *Burnet v. Sutton Oil Co., Inc. v. Commissioner*, 328 U.S. 25 (1946).

This Court early held that a cash bonus paid to a lessor in connection with the execution of an oil and gas lease was an "advance royalty" and, hence, was to be treated as other royalties. Such a bonus is included in the lessor's gross income in determining his taxable income and likewise is included in his gross income in determining statutory depletion. As to lessors, this rule is firmly established and is not challenged by the Government. See, *e.g.*, *Anderson v. Helvering*, 310 U.S. 404 (1940); *Thomas v. Perkins*, 301 U.S. 655 (1937); *Palmer v. Bender*, 287 U.S. 551 (1933); *Murphy Oil Co. v. Burnet*, 287 U.S. 299 (1932); and *Burnet v. Harmel*, 287 U.S. 103 (1932).

As to lessees, however, the Government takes a different position. It contends that the same bonus which is an advance royalty to the lessor is not an advance royalty in determining the lessee's taxable gross income but is an advance royalty in determining gross income for purposes of computing the lessee's statutory depletion allowance. Thus,

the Government says that the lessee cannot exclude the bonus or any portion thereof from his "gross income" in computing taxable income but that he must exclude the bonus as an advance royalty from his "gross income" in computing his statutory depletion allowance. This position, as anomalous as it is unfair, has been sustained in the instant case by the Courts below, apparently relying on Circuit Court decisions[1] decided before this Court's decision in *Burton-Sutton Oil Co., Inc. v. Commissioner*, 328 U.S. 25 (1946).[2]

The decisions below are in fundamental conflict with the decision of the Fifth Circuit in *Lambert v. Jefferson Lake Sulphur Company, supra.* There the taxpayers acquired the right to conduct preliminary exploratory operations and mine sulphur on certain lands. The agreement, which had many attributes of an ordinary oil and gas lease, required the taxpayers to make periodic payments during the primary term of the lease. The taxpayers deducted[3] these periodic payments in computing taxable income. The Government contended that the payments were not deductible since they were "installments of a lump-sum bonus and should be

[1] *Quintana Petroleum Co. v. Commissioner*, 143 F. 2d 588 (5th Cir. 1944); *Sunray Oil Co. v. Commissioner*, 147 F. 2d 962 (10th Cir. 1945), *cert. denied*, 325 U.S. 861; *Canadian River Gas Co. v. Higgins*, 151 F. 2d 954 (2d Cir. 1945), *cert. denied*, 327 U.S. 793; and *Baton Coal Co. v. Commissioner*, 51 F. 2d 469 (3rd Cir. 1931), *cert. denied*, 284 U.S. 674.

[2] The decision in *Burton-Sutton* was announced on April 22, 1946. Certiorari in *Canadian River Gas Co. v. Higgins, supra*, note 1, was denied on March 25, 1946. Judge Learned Hand wrote a forceful dissent in *Canadian River Gas* which further supports Petitioner here. See 151 F. 2d at 957-58.

[3] The "deduction" referred to really should be an "exclusion." See part 1 of the STATEMENT, *supra* at page 3.

'capitalized'."[4] Thus, as in the instant case, a payment was made to acquire rights to explore and produce minerals; the payment was characterized as a bonus; and the Government contended that such payment represented a capital investment. The District Court and the Fifth Circuit held the payments were advance royalties and thus were excludable from the taxpayers' gross income in computing their taxable income. Significantly, the District Court in *Jefferson Lake* stated:

> "The Fifth Circuit seems to have held that advance royalties are not excludable by the lessee in Quintana Petroleum v. Commissioner of Int. Rev., 5 Cir., 143 F. 2d 588. In Commissioner of Internal Revenue v. Gracey, 5 Cir., 159 F. 2d 324, however, the Fifth Circuit apparently admits that its decision in Quintana is contrary to the principles approved by the Supreme Court in Burton-Sutton Oil Co. v. Commissioner, supra." 133 F. Supp. 197, 200, note 10.

Further, the District Court said:

> "It would appear, however, that these quarterly payments are *excludable from income by the taxpayer as advance royalties.* Admittedly, these payments were depletable as advance royalties by the lessor. Burnet v. Harmel, supra; Bankers Pocahontas Coal Co. v. Burnet, supra; Murphy Oil Co. v. Burnet, supra; Palmer v. Bender, supra. Consequently, they should be excludable as such by the lessee. Int. Rev. Code of 1939, §114(b)(4)(A), 26 U.S.C. §114(b)(4)(A) (1946 ed.). It is true that three cases from the Second, Third and Tenth Circuits are to the contrary. But those cases are inconsistent with principles expounded by the Supreme Court in Burnet, Bankers Coal Co., Murphy Oil Co. and Palmer. In addition, they were written before the opin-

[4] See 236 F. 2d at 544.

ion of the Supreme Court in Burton-Sutton Oil Co. v. Commissioner, supra. * * *" [Emphasis added.]

The Court added:

> "It is true that in the Burton-Sutton case the payments from the operator to the owner were not characterized as bonuses or advance royalties and were, in fact, materially different therefrom in that the payments there were 50 per cent of the net profit from the mineral operation. Nevertheless, though that case may be distinguishable from the one at bar on its facts, the principle there applied is applicable here. *If the payments here are advance royalties depletable by the lessor, as admitted by the Government, then they are excludable from income as advance royalties by the lessee.*" [Emphasis added.]

The Fifth Circuit affirmed the District Court expressly holding that the Court below "had reached the correct conclusion *on the grounds assigned by it as its basis.*" 236 F. 2d at 546 [Emphasis added.][5] Thus, a direct and fundamental conflict is presented by the decision below and the *Jefferson Lake Sulphur* case.[6]

The decision of the Court below is also in conflict with principles enunciated by this Court in *Burnet v. Harmel, supra, Anderson v. Helvering, supra,* and *Burton-Sutton Oil Co., Inc. v. Commissioner, supra.*

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[5] This language has erroneously been characterized by the Court below as "dictum." It is plainly a holding.

[6] In the District Court in the instant case the Government admitted that *Jefferson Lake* "probably overruled" *Quintana Petroleum Co. v. Commissioner, supra.* This admission is significant since the *Quintana* case was one of the earlier decisions supporting the Government's treatment of the bonus in the instant case. On appeal the Government retracted this admission and instead attempted to distinguish *Jefferson Lake* from the instant case and thus from *Quintana.* It appears that the Court below agrees with Petitioner as to the interpretation of *Jefferson Lake* since it questioned the "validity" of that decision, 337 F. 2d at 678.

Burnet v. Harmel held that a bonus was an advance royalty to the lessor and hence he was denied capital gains and taxed on such bonus as ordinary income but subject to the depletion allowance.

In *Anderson v. Helvering, supra*, this Court had before it the question of who was taxable upon certain oil and gas production. The key to the answer lay in the answer to the additional question of whether a seller of oil properties had retained an economic interest in the deferred payment portion of his purchase price or whether his interest in the oil and gas properties was merely security for his purchase price. If the former, the seller was taxable on the production income paid over to him. If the latter, the purchaser was taxable upon such income. In enunciating the test to answer this question, this Court stated:

> "It is settled that the same basic issue determines both to whom income derived from the production of oil and gas is taxable and to whom a deduction for depletion is allowable. That issue is, who has a capital investment in the oil and gas in place and what is the extent of his interest." 310 U.S. at 407.

This Court further reaffirmed the *Burnet v. Harmel* rule that a bonus payment met the test of a capital investment in oil in place:

> "Cash bonus payments, when included in a royalty lease, are regarded as advance royalties, and are given the same tax consequences." 310 U.S. at 409.

These principles were again reaffirmed by this Court in *Burton-Sutton Oil Co., Inc. v. Commissioner*, 328 U.S. 25 (1946). The question in *Burton-Sutton* was whether a holder

of a "net-profits" interest in oil and gas production had an "economic interest" in oil and gas in place so that he would be entitled to the depletion deduction.[7] In holding that such an interest is an economic interest, and in characterizing the relationship between lessor and lessee with respect to types of interests in oil and gas production, this Court established the test as follows:

> "If they are capital investments to one, they are capital sales to the other. If they are rents or royalties paid out to one, they are rents or royalties received by the other." 328 U.S. at 27.

These decisions establish the tests to be applied in determining: (1) the total pool of economic interests from oil and gas production which will be entitled to the depletion allowance and (2) the manner in which this pool is to be divided among the various economic interests. A simple example illustrates the application of these principles.

Assume A (lessor) executes an oil and gas lease to B. The lease provides A is to receive a ⅛th royalty interest free and clear of any costs of production from any oil and gas produced. B is to receive ⅞ths of the production but is liable for all costs of producing the oil.[8] B pays a cash bonus to A in connection with the execution of the lease. There-

[7] This Court first held that a "net-profits" interest did not qualify as an "economic interest." See *Helvering v. Elbe Oil Land Development Co.*, 303 U.S. 372 (1938); *Helvering v. O'Donnell*, 303 U.S. 370 (1938); and *Helvering v. Bankline Oil Co.*, 303 U.S. 362 (1938). The "net-profits" interests were reconsidered in *Burton-Sutton Oil Co., Inc. v. Commissioner, supra*, and *Kirby Petroleum Co. v. Commissioner*, 326 U.S. 599 (1946) where it was determined that a "net-profits" interest did qualify as part of the pool of economic interests from oil and gas production. Thus, a net-profits interest holder is entitled to depletion.

[8] The interest of the lessee is commonly termed the "working interest" since such interest is the cost bearing interest.

after B conveys a ⅛th overriding royalty out of his ⅞ths interest to C for cash.[9] Under the principles enunciated by this Court, the total pool of economic interests entitled to depletion are: (1) the cash bonus; (2) the ⅛th lessor royalty; (3) the ⅛th overriding royalty; and (4) the remaining working interest. With respect to each interest except the bonus the rules are clear as to the division of the pool of economic interests in the lease: (1) production attributable to the ⅛th royalty of A is, of course, taxed to him, he is entitled to depletion on this interest and B (lessee) excludes this interest from his income; (2) C is taxed on income attributable to his ⅛th overriding royalty, he is entitled to depletion and B similarly excludes this interest from his income; and (3) B reports the income attributable to his working interest, deducts the costs incurred to produce the income and takes depletion on his interest. Now to the bonus. It is included in the total quantum of economic interests since otherwise the lessor (A) would not be entitled to depletion on it. *Burnet v. Harmel, supra; Anderson v. Helvering, supra.* This means that it must be treated like A's royalty and C's overriding royalty and therefore B is required to exclude the bonus from his income. This is the only manner in which the lessee can treat the bonus under the tests established by this Court for determining the total pool of economic interests and the division of this pool among the different interest owners. If the lessee does

[9] While the lessor's royalty and the royalty interest conveyed to C are similar interests, the latter is customarily termed an "overriding royalty" since it is an interest created from the ⅞ths working interest rather than the ⅛th lessor royalty interest.

not exclude the bonus from his taxable gross income, the effect is double taxation on the same economic interest.[10]

Applying these principles to the case at bar, if the bonus is an advance royalty to the lessor (which it is), it must be an advance royalty to the lessee (petitioner), in which case the $181,880 aliquot part of the bonus must be excluded from petitioner's gross income for its fiscal year ended May 31, 1953.

The decision of the Court below directly conflicts with the decisions of this Court with respect to the treatment of the bonus as an advance royalty required by *Burnet v. Harmel*, the inclusion of the bonus in the total pool of economic interests required by *Anderson v. Helvering* and the reciprocal characterization of the bonus required by *Burton-Sutton*.[11]

The Government itself recognizes that the pool of economic interests include bonuses. For purposes of computing statutory depletion Regulations, § 39.23(m)-1(e)(5), Appendix A, *infra*.[12] provide:

> "*If royalties in the form of bonus payments* have been paid in respect of the property * * * the amount ex-

[10] While the Government would attribute this economic interest to both the lessee and lessor, it would permit depletion only to the lessor. This is the effect of requiring the lessee to exclude the bonus from its gross income for purposes of computing his statutory depletion allowance.

[11] Even before its decision in *Jefferson Lake Sulphur Company*, the Fifth Circuit had noted that the decision in *Burton-Sutton* had the effect of overruling its earlier decision in *Quintana Petroleum Company*. See *Commissioner v. Gracey*, 159 F. 2d 324, 326 (5th Cir. 1947).

[12] Since the taxable year here in question (1953) is a year to which the Internal Revenue Code of 1939 applies, the Regulations promulgated thereunder (Regulations 118) are also applicable. These provisions have not changed substantially under the Regulations promulgated under the 1954 Code.

> cluded from 'gross income from the property' * * * shall be an amount equal to that part of such payments which is allocable to the product sold during the current taxable year." [Emphasis added.]

Moreover, the Government recognizes that advance royalties are proper exclusions from taxable gross income. Under section 39.23 (m)-10(e) of the Regulations, Appendix C, *infra*, dealing with the computation of taxable income, if a lessee pays an advance royalty, he deducts [excludes] this from gross income, either in the year of payment or in the year the mineral product in respect of which the advance royalty was paid is sold. However, this regulation applies only to advance royalties which the lessee is required to pay "on a specified number of units of minerals annually, whether or not extracted within the year." A cash bonus paid in connection with the execution of an oil and gas lease is not, under these regulations, regarded as an advance royalty even though it is undisputed that it is taxed to the lessor as an advance royalty.[13]

Since it is undisputed that the bonus is an advance royalty under well established and settled principles of this Court, the above regulation must be invalid as contrary to the decisions of this Court to the extent such regulation does not accord bonuses the same treatment as other advance royalties.

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[13] In the instant case, of course, the lessor paid no tax on the bonus received since it was the United States. However, the character of the payment is still that of an advance royalty. Had the lessor in the instant case been a person subject to tax, the bonus would have been included in his income as an advance royalty, *i.e.*, ordinary income subject to depletion.

2. Petitioner contends, in the alternative, that if the bonus paid to the United States is not to be excluded from its taxable gross income then it similarly should not be excluded from its depletable gross income. Surely "gross income" means the same thing both in section 22(a) and in section 114(b)(3) of the 1939 Code and the inconsistent treatment required by Treasury Regulations, *viz.*, that petitioners must *include* the bonus in taxable gross income but must *exclude* the bonus from depletable gross income cannot be justified. It is a clear rule of statutory construction that identical words used in the same statute are presumed to have identical meaning. *Helvering v. Wilshire Oil Co., Inc.*, 308 U.S. 90 (1939); *Commissioner v. Ridgeway's Estate*, 291 F. 2d 257 (3rd Cir. 1961).

It is difficult enough, in light of *Burton-Sutton Oil Co., Inc., supra*, to justify giving the bonus one treatment to the lessor and a different one to the lessee. A fortiori, there can be no possible justification in holding it to be two different things at the same time to the lessee, *viz.*, that it is a capital investment in computing the lessee's "gross income" subject to tax, but is an advance royalty in computing "gross income" subject to percentage depletion; that it is the lessee's capital investment in computing cost depletion, but is an advance royalty in Computing statutory depletion. In fact, in order to avoid the effect of the *Anderson v. Helvering*, *Burton-Sutton* and *Jefferson Lake*, the Government's position must be to insist, despite *Burnet v. Harmel*, 287 U.S. 103 (1932) and *Murphy Oil Co. v. Burnett*, 287 U.S. 299 (1932), that a bonus is not a royalty. This position inevitably leads to the conclusion that if a bonus is not a royalty to be

excluded from the lessee's taxable "gross income", it cannot be a royalty to be excluded from the lessee's depletable "gross income"; and if it is not a royalty to be excluded from the lessee's depletable "gross income", the "bonus exclusion" provisions of Regulations, Section 39.23(m)-1(e)(5), are clearly invalid.

Quintana Petroleum Co. v. Commissioner, *supra*, and the other Circuit Court cases above mentioned, to the extent that they sanction the "bonus exclusion", while at the same time holding the bonus not to be a royalty to the lessee, are clearly wrong. In *Jefferson Lake* the Fifth Circuit so held in overruling the *Quintana* case.

3. Although the Circuit Court decisions sustaining the Government's position are far from clear, apparently they felt it necessary to reach such a result to avoid "double depletion." Petitioner has clearly demonstrated that since the bonus is included in the total pool of economic interests, there would be a doubling-up of depletion only in the sense that there is also a doubling-up of taxable income. Since, in this case, the United States is the lessor and hence took no depletion, the supposed reason for sustaining the exclusion from depletable gross income vanishes. Accordingly, Petitioner should not be required to exclude the bonus from depletable gross income in this case.

4. We submit that the recurring importance of the problem in the administration of the tax laws and the conflict between the decisions below and those of this Court and the Court of Appeals for the Fifth Circuit warrant review and a definitive adjudication of the issue by this Court.

Bonus payments in connection with the execution of oil and gas leases are standard and customary in the entire industry. Major oil companies and independent oil producers pay out millions of dollars every year in lease bonuses. In the interest of uniform administration of our tax laws they are entitled to consistent treatment of the bonus. Not only are the present rules inconsistent, they are not uniformly applied. In some areas companies are eprmitted to exclude the bonus or an aliquot part thereof from taxable gross income; in some areas companies are permitted to capitalize the bonus and not exclude it from depletable gross income; and in some areas companies are required to follow the inconsistent treatment provided in the regulations. The reason for this lack of uniform administrative enforcement is not clear. The issue has seldom been raised and Regulations largely ignored. Since the issue has been raised in the case at bar, it is time this Court hear the issue and resolve it consistent with its earlier decisions.

Moreover, every writer who has considered this question has criticized the existing rules as promulgated in the Treasury Regulations[14] and Treasury officials informally have criticized them as the ancient "swoose", neither swan nor goose. Since the mid-1940s no court or writer has attempted to justify the Government's position on the merits. Even these earlier cases are unconvincing in their attempt to rationalize a dual inconsistent treatment of the bonus. This

[14] See, *e.g.*, Gilpin, "Special Depletion Problems Relating to Gas Production, 12th Ann. S.W. Legal Foundation Inst. on O.&G. Law and Tax., 347, 418 (1961) and Freling, Bonus Payments Through the Looking Glass, P-H Oil & Gas Taxes, ¶ 2027 (1962).

is especially true in light of Judge Learned Hand's dissent in the *Canadian River Gas* case, and the Fifth Circuit's decision in *Jefferson Lake* which overrules its earlier decision in *Quintana*.

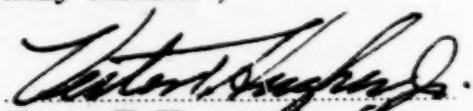
The tax rules governing oil and gas transactions are largely interpretative and do not result from a highly articulated statutory pattern. In light of this approach to oil and gas tax law, this Court should hear and decide this issue.

In addition, the identical issue is now pending in the Fifth Circuit in *Shamrock Oil and Gas Corp. v. Commissioner*, 35 T.C. 979. Petitioner is advised that the *Shamrock* case will probably not be decided in the Fifth Circuit until late spring, and unless the Fifth Circuit overrules its decision in the *Jefferson Lake Sulphur Company* case, the *Shamrock* decision will present a second conflict with the decision below in the instant case. Accordingly, since that decision would present a further conflict, presumably this Court would grant certiorari in that case if it is not granted here. But at such later date Petitioner would be without remedy if this Court sustains the principle for which Petitioner is here contending. Moreover, review is justified now by the need to resolve the existing conflict between the Eighth and Fifth Circuits and between the Eighth Circuit and principles enunciated by this Court.

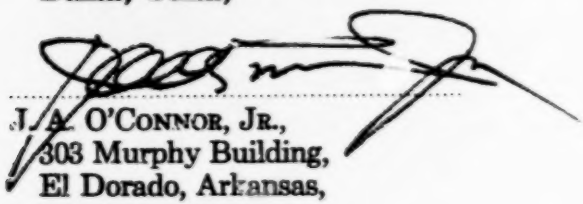
CONCLUSION

For the foregoing reasons, Petitioner respectfully submits that this petition for writ of certiorari should be granted.

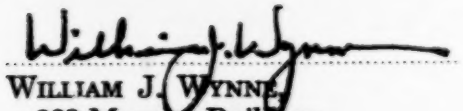
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CERTIFICATE OF SERVICE

I, Vester T. Hughes, Jr., one of the attorneys for Murphy Oil Corporation, Petitioner herein, and a member of the Bar of the Supreme Court of the United States, hereby certify that on the 9th day of February, 1965, I served copies of the foregoing Petition for Writ of Certiorari upon the Solicitor General, Department of Justice, Washington 25, D. C., by air mail, postage prepaid, and upon counsel of record who represented the United States of America, Respondent herein, in the court whose judgment is sought to be reviewed, in accordance with paragraph 2(a) of Rule 33 of the rules of this Court.

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APPENDIX A

IN THE UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF ARKANSAS
EL DORADO DIVISION

No. E.D. 989

MURPHY CORPORATION,

Plaintiff,

v.

UNITED STATES OF AMERICA,

Defendant.

Memorandum Opinion

This is a suit brought by plaintiff, Murphy Corporation, against the Government to secure a refund of a portion of its 1953 federal income tax allegedly unlawfully and erroneously exacted. The problem presented is the proper treatment for tax purposes of an aliquot part of a cash "bonus" which plaintiff paid to the Government in 1951 for an interest in an oil and gas lease on certain federally owned lands in Bossier Parish, Louisiana, from which lands oil and gas were produced in commercial quantities during the tax year in question. The cause has been submitted to the Court on the pleadings, a written stipulation of all controlling facts, and memorandum briefs.

Plaintiff has its principal place of business in El Dorado, Union County, Arkansas, and files its federal tax returns with

the District Director of Internal Revenue at Little Rock. During 1953 and prior years plaintiff was largely engaged in the production of oil and natural gas from wells located in Arkansas, Louisiana, and elsewhere.

In the spring of 1951 the Government advertised for bids for an oil and gas lease covering certain lands in the Barksdale Airforce Base near Shreveport, Louisiana. The advertisement announced that the lands would be leased for a cash bonus to be paid in advance, and for a royalty of one-eighth of the oil and gas produced from the properties. Plaintiff, acting through an agent, submitted a bid and obtained a one-half interest in a lease which the Government executed later in the year. The amount of bonus which plaintiff paid for its interest was $2,273,500.

In computing its income taxes from year to year plaintiff takes advantage of the depletion allowance provisions of sections 611 and 613(b)(3) of the Internal Revenue Code of 1954 and with respect to 1953 claimed a depletion allowance as provided by sections 23(m) and 114(b)(3) of the Internal Revenue Code of 1939. Since the rights of the parties are governed by the 1939 Code further Code references are to that Code. Likewise, references to regulations are to those promulgated under the 1939 Code.

Under sections 23(m) and 114(b)(3) lessors and lessees of oil or gas producing properties were entitled to claim as deductions from their income for tax purposes annual allowances of 27.5 percent of gross income from the leased premises during the taxable year to compensate for the

depletion of oil and gas in the ground. The allowances were required to be prorated equitably between lessors and lessees, and the lessees were required by section 114(b)(3) to exclude from gross income from the properties "an amount equal to rents or royalties paid or incurred by the taxpayer in respect of the property." The reason for the latter requirement was, and is, that rents and royalties paid to lessors are taxable income to them against which they are entitled to claim depletion, and unless the lessees are required to eliminate such rents and royalties from gross income from the properties when calculating their own depletion allowances, there would be a duplication of the allowances.

With regard to a cash bonus paid for an oil and gas lease,[1] it is settled law that as far as the lessor is concerned, the money which he receives by way of bonus is taxable income against which depletion allowances may be claimed. See Anderson v. Helvering, 310 U.S. 404; Bankers Pocahontas Coal Co. v. Burnet, 287 U.S. 308; Murphy Oil Co. v. Burnet, 287 U.S. 299; Burnet v. Harmel, 287 U.S. 103.

The lessee, of course, is taxed ultimately upon his or its net income, which is gross income as defined by section 22 of the Code, less the deductions authorized by section 23, including depletion allowances. In determining a lessee's gross

[1] A "cash bonus" for an oil and gas lease is simply a cash payment made to the lessor in consideration of the execution of the lease. It has no relation whatever to actual production from the leased premises and is not affected by production or lack of production. Normally, if production is achieved, the lessor receives a royalty of one-eighth of the oil and gas produced free and clear of all costs of production; the lessee receives the remaining seven-eighths of the production out of which he must recover his investment, pay operating expenses and derive his profit, if any.

income under section 22 the Treasury has consistently taken the position that the amount of cash bonus paid for the lease is a capital investment and cannot be excluded from gross income for section 22 purposes. For section 22 purposes the bonus is not regarded as "advance royalty" because it has no relation to actual production from the properties. See in this connection Treasury Regulations 118, §§ 39.23(m)-10(a) and (e).

However, as far as the depletion allowance is concerned, the Treasury has taken the view that a bonus paid for a lease must be treated like an "advance royalty," and must be excluded from gross income from the property when the annual depletion allowance is calculated. In this connection section 39.23(m)-1(e)(5) provides in part that if "royalties in the form of bonus payments have been paid in respect to the property in the taxable year or any prior years * * * the amount excluded from 'gross income from the property' for the current taxable year on account of such payments shall be an amount equal to that part of such payments which is allocable to the product sold during the current taxable year * * *."

Thus, it will be seen that when the lessee comes to calculate his income tax, he is not permitted to exclude the bonus payment from gross income for section 22 purposes, but must exclude an aliquot part of it from his gross income when computing his depletion allowance under section

23(m).[2] It is this alleged inconsistency in the treatment of the bonus in determining the lessee's tax liability which gives rise to this lawsuit. Plaintiff contends, alternatively, that if the bonus must be excluded from gross income for purposes of computing depletion allowance under sections 23(m) and 114(b)(3), it must also be excluded from gross income for section 22 purposes, or that if it is to be included in gross income for purposes of section 22, it must also be included for purposes of sections 23(m) and section 114(b)(3). These alternative contentions were brought before the Court in the following manner:

The portion of the bonus paid by plaintiff in 1951 and allocable to 1953 was $181,880. When plaintiff prepared and filed its income tax return for 1953 it excluded the sum just mentioned both in its initial computation of gross income under Section 22 and in its computation of depletion allowance under section 23(m) and section 114(b)(3). Having so excluded that sum from gross income, plaintiff proceeded to calculate and pay the resulting tax. The Commissioner disallowed the double exclusion of the bonus and assessed a deficiency of $73,069.77. Plaintiff paid this deficiency and when its claim for a refund was denied administratively, it commenced this action.

[2] In view of this situation it is perhaps fair to say that a lessee who claims the statutory depletion allowance is never able to recover the amount of the cash bonus, *as such*. This does not mean necessarily that the bonus payment in fact will not be recouped by the lessee if production is efficient and continues. By continually availing himself of the 27.5 percent depletion allowance from year to year a lessee may recoup all of his investment, including the bonus, and much more.

It is the position of the Government that regardless of consistency or inconsistency in the treatment of the bonus when determining the tax liability of the lessee, the regulatory scheme whereby the lessee must exclude an aliquot part of the bonus from gross income when computing his depletion allowance but is not permitted to exclude it when computing his gross income under section 22 has the force of law, and that plaintiff is not entitled to prevail.

The contention advanced by plaintiff is not novel. It has been considered and rejected by the Courts of Appeals for four Circuits, Sunray Oil Co. v. Commissioner, 10 Cir., 147 F. 2d 962; Canadian River Gas Co. v. Higgins, 2 Cir., 151 F. 2d 954; Baton Coal Co. v. Commissioner, 3 Cir., 51 F. 2d 469; Quintana Petroleum Co. v. Commissioner, 5 Cir., 143 F. 2d 588. More recently, it has been rejected by the Tax Court in Shamrock Oil & Gas Corporation v. Commissioner, 35 T.C. 979, 1040 ff., and in Fitzsimons v. Commissioner, 37 T.C. 179.[3]

In an effort to avoid the force of the Courts of Appeals' decisions just cited counsel for plaintiff contends that those decisions have been overruled by implication by the holdings of the Supreme Court in Kirby Petroleum Co. v. Commissioner, 326 U.S. 599, and Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25, and that the Quintana Petroleum

[3] The Shamrock case, supra, is now on appeal to the Court of Appeals for the Fifth Circuit, and this Court suggested at one time that decision of the instant case await the determination of the Court of Appeals in *Shamrock*. However, counsel on both sides requested the Court to proceed to decision here at this time since the date of the appellate court's decision in *Shamrock* is uncertain. Having considered the matter, the Court decided to accede to coursels' request.

Co. case has been in effect overruled by the Court of Appeals for the Fifth Circuit in Lambert v. Jefferson Lake Sulphur Co., 5 Cir., 236 F. 2d 542, affirming Jefferson Lake Sulphur Co. v. Lambert, E.D. La., 133 F. Supp. 197.

While there is some language in the Burton-Sutton case which perhaps lends some support to plaintiff's contention, neither Burton-Sutton nor Kirby Petroleum involved the problem presented here, and for that reason neither case can be considered as directly in point. Nor is the Court persuaded that the Supreme Court in either case intended to overrule or criticize the results reached in the cases typified by Sunray Oil Co. v. Commissioner and Canadian River Gas Co. v. Higgins, both supra.

It may be conceded that Judge J. Skelly Wright took a broad view of the holding in Burton-Sutton, and rendered a decision in Jefferson Lake Sulphur Co. v. Lambert, supra, 133 F. Supp. 197, which is consistent with the position assumed by plaintiff here. And it is true that the Court of Appeals in that case affirmed the decision of the District Court. However, the weight to be given here to the affirmance in Lambert is diminished by the fact that the affirmance was based primarily on an entirely different ground from that on which the district court proceeded, and thus the language in the opinion of the Court of Appeals approving the reasoning of the district court may be considered as dictum.

In the Shamrock case, supra, the Tax Court discussed the question in great detail and declined to follow the Jeffer-

son Lake case. Similarly, the Tax Court specifically refused to follow *Jefferson Lake* in Fitzsimons v. Commissioner, supra. In both *Shamrock* and *Fitzsimons* the view was taken that Burton-Sutton Oil Co. v. Commissioner, supra, was not in point.

With the law in the state that has been outlined, this Court does not feel justified in holding at this time that the older cases upholding the Government's position have been overruled, or that the decisions of the Tax Court in *Shamrock* and *Fitzsimons* were wrong, or that the regulatory scheme of which plaintiff complains is invalid. Before so holding this Court would require a stronger showing of a change in the law than has been made.

Plaintiff advances in its briefs another contention which appears to the Court to be subsidiary to the principal contentions which have been mentioned. This contention is that in no event should plaintiff be required to exclude the aliquot part of the bonus from gross income for depletion allowance purposes since the Government is not a taxpayer and does not claim depletion allowances as do private lessors. The Court is convinced that this subsidiary contention is devoid of merit. The depletion allowance is a matter of legislative grace, and the statutory requirement that rents or royalties be excluded from a lessee's gross income for depletion allowance purposes does not depend upon the status of the lessor as a taxpayer. That the Government pays no income tax and takes no depletion allowances is no reason

to give plaintiff the benefit of an additional allowance to which it would not be entitled were the lessor a private individual or corporation.

From what has been said, it follows that the complaint must be dismissed.

Dated this 1st day of April, 1964.

J. SMITH HENLEY

United States District Judge

APPENDIX B

United States Court of Appeals

FOR THE EIGHTH CIRCUIT

No. 17,666

MURPHY OIL CORPORATION,

Appellant,

v.

UNITED STATES OF AMERICA,

Appellee.

Appeal from the United States District Court for the Western District of Arkansas.

[October 28, 1964.]

Before MATTHES, BLACKMUN and RIDGE, Circuit Judges.

PER CURIAM.

Murphy Oil Corporation, Appellant, brought this action to recover income taxes alleged to have been erroneously and illegally assessed and collected by the Government for the taxable year ending May 31, 1953.

The facts were presented by a stipulation, are fully and accurately stated in the trial court's opinion, and place in issue the proper treatment for tax purposes, under applicable statutes and Treasury Regulations, of an aliquot part of a cash bonus which appellant paid to the Govern-

ment in 1951 for an interest in an oil and gas lease on federally owned land in Louisiana.

Appellant's claim for refund is premised on the theory that the bonus paid by it is an advance royalty and that an aliquot part thereof should be excluded from appellant's gross income in determining both taxable income and statutory depletion; that if the cash bonus is not to be excluded from its gross income in computation of taxable income such bonus should not be excluded from gross income for purpose of computing its statutory depletion; and that in any event Treasury Regulation 39.23(m)-1(e)(5) under the 1939 Internal Revenue Code is invalid insofar as it requires the bonus exclusion in a situation where, as here, the recipient of the bonus is a governmental agency.

The trial court, Judge Henley, after carefully considering appellant's contentions, the applicable statutes and regulations, and what is regarded as the controlling decisional law, concluded that appellant was not entitled to recover and dismissed the complaint. 230 F. Supp. 583 (1964). This appeal follows.

A thorough examination of the authorities cited and others having any relevancy to the question presented satisfies us that the judgment appealed from is correct and we affirm on the basis of the trial court's opinion. Like Judge Henley, we are not persuaded that *Burton-Sutton Oil Co. v. Commissioner*, 328 U.S. 25 (1946) has the effect of changing the law as announced by the Courts of Appeals and by the Tax Court in cases cited in the trial court's opinion. Since the issue presented in this case was

not before the Supreme Court in *Burton-Sutton*, we have difficulty in adopting appellant's suggestion that the broad generalization contained in the two sentences taken from the *Burton-Sutton* opinion demonstrates fundamental error in the prior decisions of the Courts of Appeals.[1]

Jefferscn Lake Sulphur Co. v. Lambert, 133 F. Supp. 197, affirmed 236 F. 2d 542 (1956) which lends support to appellant's position was in our view influenced in large part by the statements of the Supreme Court in *Burton-Sutton*, quoted in the margin. Inasmuch as we do not regard such language, seemingly controversial, as having the effect of overruling long standing Treasury Regulations and decisional law, the validity of *Jefferson Lake* is in our view, greatly diminished and certainly it does not control the disposition of this case.

Affirmed.

A true copy.

Attest:

Clerk, U. S. Court of Appeals, Eighth Circuit.

[1] In *Burton-Sutton* the court was concerned with the tax treatment of a lease payment in the form of net profits. In its discussion, the court made these statements seized upon by appellant in support of its contentions; 328 U.S. at page 27. "If they are capital investments to one, they are capital sales to the other. If they are rents and royalties paid out to one, they are rents and royalties recieved by the other." We note that Freling, *Bonus Payments Through the Looking Glass*, P-H OIL & GAS TAXES ¶ 2027 (1926) cited by appellant, takes issue with the court's view in this language: "At least one sentence in the foregoing quotation from *Burton-Sutton* is incorrect, and the Tax Court [Shamrock Oil & Gas Corp. 35 T.C. 979, 1054. et seq. (1961)] rightly makes short shrift of the notion. Merely because an expenditure is a capital investment to the payor does not necessarily mean that there has been a capital sale by the payee." Page 2514 of § 2027.

APPENDIX C

Statutes and Regulations Involved:

Statutes:

Internal Revenue Code of 1939:

Section 23(m) [now INT. REV. CODE OF 1954 § 611 (a)]: "*Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the

trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

"For percentage depletion allowable under this subsection, see section 114(b), (3) and (4)."

Section 114(b) (3) [now INT. REV. CODE OF 1954 § 613(a), (b)]: "*Percentage Depletion for Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion under section 23(m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23(m) be less than it would be if computed without reference to this paragraph."

Regulations 118:

Section 39.23(m)-1(e) (5) [now Treas. Reg. § 1.613-2(c) (5) (i), (ii), (iii) 1960]: "In all cases there shall be excluded in determining the 'gross income from the property' an amount equal to any rents or royalties which were paid or incurred by the taxpayer in respect of the property and are not otherwise excluded from the 'gross income from the property'. If royalties in the form of bonus payments have been paid in respect of

the property in the taxable year or any prior years, or if advanced royalties have been paid in respect of the property in any taxable year ending prior to December 31, 1939, the amount excluded from 'gross income from the property' for the current taxable year on account of such payments shall be an amount equal to that part of such payments which is allocable to the product sold during the current taxable year. If advanced royalties have been paid in respect of the property in any taxable year ending on or after December 31, 1939, the amount excluded from 'gross income from the property' for the current taxable year on account of such payments shall be an amount equal to the deduction for such taxable year taken on account of such payments pursuant to § 39.23(m)-10(e)."

Section 39.23(m)-10(e) [now Treas. Reg. § 1.612-3(b) (1), (2), (3) (1960)]: "If a lessee or other owner of operating rights in one or more mineral properties is required to pay royalties on a specified number of units of mineral annually, whether or not extracted within the year, and may apply any amounts paid on account of units not extracted within the year against the royalty on mineral thereafter extracted, he may at his option treat the advanced royalties so paid or accrued in either one of the following manners:

"(1) As deductions from gross income for the year the advanced royalties are paid or accrue; or

"(2) As deduction from gross income for the year the mineral product in respect of which the advanced royalties were paid is sold.

The option contained in this paragraph shall apply only to advanced royalties paid or accrued in taxable years ending on or after December 31, 1939. Every taxpayer must make an election as to the treatment of all such advanced royalties in his return for the first taxable year ending on or after December 31, 1939, in which such amounts are paid or accrue. A taxpayer will be considered to have made an election in accordance with the manner in which such items are treated in the return. A failure to deduct any such items for the year paid or accrued will constitute an election to have all such items treated in accordance with subparagraph (2) of this paragraph. Any election made under this section is binding for all subsequent years and the taxpayer must treat all advanced royalties paid or accrued in such subsequent years in the same manner."

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MAR 30 1965
JOHN F. DAVIS, CLERK

In the

Supreme Court of the United States

OCTOBER TERM 1964

No. 899

MURPHY OIL CORPORATION,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

AMICUS CURIAE BRIEF IN SUPPORT OF THE PETITION FOR WRIT OF CERTIORARI

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Argument:

The Petition for Writ of Certiorari should be granted to resolve the conflict between Courts of Appeal on an important question of Federal tax law that has not been, but should be, settled by this Court, consistent with fundamental principles announced by this Court in prior decisions which will require a reversal of the decision below, and because an additional conflict exists between the Court of Appeals for the Fifth Circuit on the one hand and the Court of Appeals for the Eighth Circuit and the Tax Court on the other hand as to the meaning of this Court's decision in Burton-Sutton Oil Co. v. C.I.R., 328 U.S. 25, and its application to the issue presented in the instant case 2

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CONSENT OF PARTIES

This amicus curiæ brief in support of the Petition for Writ of Certiorari is filed with the consent of the parties herein. Letters from the respective counsel for petitioner and respondent granting such consent have been filed with the Clerk of this Court.

INTEREST OF AMICUS CURIAE

The question presented herein is identical to one of the issues presented in Cause No. 21,067 in the United States Court of Appeals for the Fifth Circuit, styled *The Shamrock Oil and Gas Corporation, Petitioner, v. Commissioner of Internal Revenue, Respondent*, submitted and orally argued February 22, 1965, on petition to review the de-

cision of the Tax Court of the United States in *The Shamrock Oil and Gas Corporation v. Commissioner of Internal Revenue*, 35 T.C. 979. The undersigned attorney filing this amicus curiæ brief is counsel of record for the petitioner in *The Shamrock Oil and Gas Corporation* case. Because of the identity of issues presented in the instant case and in *The Shamrock Oil and Gas Corporation v. Commissioner of Internal Revenue*, the undersigned attorney and his client, though having no interest in this case, are vitally interested in the final result of these proceedings. This amicus curiæ brief is presented on behalf of the undersigned attorney and his client, The Shamrock Oil and Gas Corporation.

ARGUMENT

The issue herein, decided by the Eighth Circuit, and pending in the Fifth Circuit in the *Shamrock* case, presents an important question of Federal tax law which has not been, but should be, settled by this Court, not only because of the importance of such question, but because of the conflict in the decisions between the United States Courts of Appeal for the Eighth Circuit and the Fifth Circuit and the conflict between the decision herein and the fundamental concepts of tax law announced by this Court in the hereafter cited cases.

The question, presented herein, of how a lessee should treat, for Federal income tax purposes, cash bonuses paid for the acquisition of an oil and gas lease is of substantial importance, not only to the oil and gas industry but to the

Commissioner of Internal Revenue which, it is submitted, can only be resolved by an opinion of this Court settling the disagreement between such Courts of Appeal as to the application of this Court's decision in *Burton-Sutton Oil Company v. Commissioner of Internal Revenue*, 328 U.S. 25, to the lessee's tax treatment of a cash bonus. On this issue the Court of Appeals for the Eighth Circuit in the instant case, as well as the Tax Court in *The Shamrock Oil and Gas Corporation v. Commissioner*, 35 T.C. 979, are in direct conflict with the Court of Appeals for the Fifth Circuit in *Lambert v. Jefferson Lake Sulphur Company*, 236 Fed. 2d 542, affirming *Jefferson Lake Sulphur Company v. Lambert* (E.D.La.) 133 Fed. Supp. 197.

In the *Jefferson Lake Sulphur Company* case, the Fifth Circuit concluded that this Court's decision in *Burton-Sutton Oil Company*, supra, had rejected the Government's contention, made in the *Jefferson Lake Sulphur Company* case (likewise made by the Government in the instant case, and adopted by the Eighth Circuit herein), that cash payments made for the acquisition of a lease were "bonuses recoverable only through depletion." The decision of the Eighth Circuit, as well as the District Court in the instant case, take the directly opposite view that this Court's decision in *Burton-Sutton Oil Company* is not applicable to cash bonuses and is not decisive of the issue raised herein.

It is true that *Burton-Sutton Oil Company* involved a net profits payment rather than a cash bonus, but the fundamental principles determining the tax liability, as between the lessee-payor and the lessor-recipient of a

cash bonus and of a net profits payment, are the same. The decision in *Burton-Sutton Oil Company* is not to be disregarded in deciding the instant case merely because it involved a net profits payment rather than a cash bonus, since this Court's decision in *Burton-Sutton Oil Company* is founded on a determination of which of the parties payor and payee held the economic interest in the property.

It is submitted that the decisions of the Eighth Circuit and of the District Court in the instant case are wrong, and that the decisions of the Fifth Circuit and of the trial court in *Jefferson Lake Sulphur Company* are correct, but in either event, because of the conflicting views as to the application of this Court's opinion in *Burton-Sutton Oil Company*, the petition for writ of certiorari should be granted in order that the uncertainties surrounding this important question of Federal tax law may be clarified and decisively settled by a decision and opinion on the merits. A denial of the petition for certiorari would leave unsettled the issue presented in the instant case and in *The Shamrock Oil and Gas Corporation v. Commissioner* since, under the established practice of this Court, such a denial is not a precedent for like action in a similar case.

Under the decisions of the Court of Appeals and the trial court herein, as well as the decision of the Tax Court in *The Shamrock Oil and Gas Corporation*, a cash bonus payment, though treated as an advance royalty when received by the lessor-payee suddenly "constitutes a capital investment in the property recoverable only through the depletion allowance" (Reg. 118, Sec. 39.23(m)-10(a)) as to the lessee-

payor, which cannot be excluded or deducted when lessee-payor computes his taxable income. However, when the lessee so treats such payment as a capital investment and computes his depletable income, such payment suddenly becomes a royalty which must be deducted from the gross income from production on an allocate basis, based on the anticipated productive life of the lease, before computing income subject to the statutory depletion allowance (Reg. 118, Sec. 39.23(m)-1(f)(5)), even though the lessee is required by Sec. 114(b)(3) of the 1939 Revenue Code to take percentage depletion instead of cost depletion where percentage depletion is greater.

The effect of the Regulations and decision herein is acknowledged in the trial court's opinion in the instant case and by the Tax Court in the *Shamrock* case to deprive the lessee of the right of recovering the cash bonus payment through the percentage depletion allowance, even though the lessee is required to treat such bonus payment as a capital investment and not as an advance royalty to be excluded or deducted in computing taxable income. This result is contrary to the provisions of Sec. 23(m) and Sec. 114(b)(3) of the Internal Revenue Code of 1939 providing for the depletion allowance and should not be allowed to stand.

The inconsistent treatment of the same bonus payment as an advance royalty to lessor and a capital investment by lessee, and the further inconsistent treatment as to the lessee of the same bonus payment as both a capital investment and as a royaly results in taxing the lessee on income that has already been taxed to the lessor as an advance royalty.

Burton-Sutton Oil Company repudiates such absurd result and outlines the guide lines for determining the issue here presented. The Fifth Circuit's opinion in *Jefferson Lake Sulphur Company* follows such guide lines while the opinions below in the present case assert such guide lines are not applicable or controlling with respect to cash bonus payments.

A cash bonus paid by a lessee to a lessor and royalties payable on production to a lessor under an oil and gas lease are both consideration for the lease and income to the lessor. *Burnet v. Harmel*, 287 U.S. 103. Insofar as the lessor is concerned, there is no distinction between a bonus and a royalty and both constitute ordinary income subject to depletion in the hands of the lessor. *Burnet v. Harmel*, supra; *Murphy Oil Company v. Burnet*, 287 U.S. 299; *Palmer v. Bender*, 287 U.S. 551; *Herring v. Commissioner*, 293 U.S. 322; *Anderson v. Helvering*, 310 U.S. 404; *Douglas v. Commissioner*, 322 U.S. 275.

This consistent treatment of bonuses and royalties as to a lessor was extended to a net profits payment received by a lessor in *Kirby Petroleum Company v. C.I.R.*, 326 U.S. 599. In *Burton-Sutton Oil Company v. C.I.R.*, supra, this Court held a net profits payment paid by a lessee was deductible in computing its taxable income. This Court grounded its decision in *Burton-Sutton Oil Company* on the economic interest concept and held, since the lessor held the economic interest in the property and must look to the income from the property for a return of its capital investment, that the net profits payment must be treated as ordinary income to

the lessor, subject to the depletion allowance, and the lessee-payor of such net profits payment could and should deduct such payment from the gross receipts or taxable income.

There is an exact parallel between bonus payments and net profits payments as was recognized by the Court of Appeals in *Lambert v. Jefferson Lake Sulphur Company*, supra, and the District Court in such case, *Jefferson Lake Sulphur Company v. Lambert*, 133 Fed. Supp. 197, where this Court's opinion in *Burton-Sutton Oil Company* was held controlling as to the lessee's treatment of cash bonus payments as well as lessee's treatment of net profits payment. The contrary view is taken by the courts below in the instant case. The Court of Appeals herein takes a narrow view of this Court's decision in *Burton-Sutton Oil Company* and looks only to two sentences from this Court's opinion, 328 U.S. at page 27, i.e.:

> "If they are capital investments to one, they are capital sales to the other. If they are rents and royalties paid out to one, they are rents and royalties received by the other."

The Eighth Circuit Court opinion refers to these sentences as presenting a "broad generalization", and questions the accuracy of such sentences in Footnote 1 to the Court of Appeals opinion. The Fifth Circuit, as did the District Court in *Jefferson Lake Sulphur Company*, takes a broader view of the holding in *Burton-Sutton Oil Company*, to which it is believed such opinion is entitled, and ascribes to such sentences the full effect to which they are entitled, both

when standing alone and when read in the context of the entire decision.

All incongruities resulting from the inconsistent treatment of a cash bonus first as lessee's capital investment and then as a royalty in respectively determining the lessee's taxable and depletable income would be eliminated by recognizing, as the Fifth Circuit recognized, consistent with this Court's opinion in *Burton-Sutton Oil Company*, that such payment is an advance royalty as to the lessee who pays it just as it is consistently held to be an advance royalty to the lessor who receives it. If this were done, the cash bonus, like other royalties, would be taxed to the lessor as ordinary income subject to depletion, the lessee would exclude such payment from his taxable income and would exclude, under existing regulations, an allocate part of such payment from the proceeds of the oil or gas, as produced, in determining lessee's income from production on which the depletion allowance is to be computed.

If, on the other hand, contrary to the principles announced by this Court in the before cited cases, the cash bonus is finally held to be lessee's capital investment, then the lessee should not be deprived of his right to recover such investment, through statutory depletion, by holding the very same payment has suddenly become a royalty to be deducted from the income from production before computing percentage depletion on the remaining income and thereby defeating the lessee's right to recover his capital investment (if such it be) "through the depletion allowance."

It is submitted that regardless of the ultimate disposition of the issue presented herein, such important question of Federal tax law will not be settled until this Court has, by an opinion, directly passed upon the lessee's proper treatment, for Federal tax purposes, of a cash bonus paid for the acquisition of an oil and gas lease to one who retains an economic interest in the leased property. The conflict in the decisions in the Eighth and Fifth Circuits and the disagreement between such Courts of Appeal as to the meaning and effect of this Court's decision in *Burton-Sutton Oil Company* cannot be resolved without an opinion by this Court.

CONCLUSION

For all of the reasons herein assigned, it is respectfully submitted that this Court's discretion should be exercised in favor of granting the Writ of Certiorari that has been applied for in order that there may be a final disposition of a troublesome question of substantial import consistent with the prior opinions of this Court.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I, W. M. SUTTON, Amicus Curiæ, and a member of the Bar of the Supreme Court of the United States, hereby certify that on the 29 day of March, 1965, I served copy of the foregoing Amicus Curiæ Brief in Support of the Petition for Writ of Certiorari on the Solicitor General, Department of Justice, Washington 25, D. C., and upon an attorney of record who represented the United States of America, Respondent in these proceedings, in the Court whose judgment is sought to be reviewed, and upon Vester T. Hughes, Jr., counsel for Petitioner, Murphy Oil Corporation, by Air Mail postage prepaid, by depositing same in the United States mail, properly addressed.

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No. 899

In the Supreme Court of the United States

OCTOBER TERM, 1964

MURPHY OIL CORPORATION, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

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This case concerns the proper treatment, for income tax purposes, of a lease bonus paid in connection with the acquisition of oil and gas leases in three tracts of land. The taxpayer-lessee has contended that an aliquot part (the portion allocable to the taxable year, $181,880) of the lease bonus paid by it as lessee is (1) excludible from its gross income in determining taxable income and, if not, then that (2) it must be included in its percentage depletion base (its gross income from the property). The decision below rejecting both contentions is in accord with the pertinent Treasury Regulations and decisional law.

Under the pertinent Treasury Regulations, production income in the amount of the lease bonus is in-

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cluded in the lessor's depletion base and excluded from the lessee's depletion base (gross income from the property). Treasury Regulations 118 (1954 Code), Sections 39.23(m)-1(e)(5) and 39.23(m)-10 (a) and (b). On the other hand, unless the lease bonus is an advance royalty (as representing a required payment on a specified number of units annually, not true in the present case), it is a capital investment as to the lessee. *Ibid.* As such it cannot be deducted from the gross income received by the lessee (which includes the amount of production income included in the lessor's depletion base). Thus, the result is that, although an amount of production income equal to the lease bonus must be excluded from the lessee's depletion base for percentage depletion purposes, that amount nevertheless constitutes taxable income to the lessee. This conclusion may seem anomalous, but it is required by long standing Treasury Regulations and was approved by two different circuits even prior to the decision below by still another circuit.[1] *Sunray Oil Co.* v. *Commissioner,* 147

[1] Inherent in the rule so established is the fact that although both parties, as here, have realized income in the amount of the lease bonus—the lessor from the bonus itself and the lessee from actual operations under the lease—only one depletion deduction can be given on a given unit of oil production. The Commissioner, under a statutory grant of authority calling for an apportionment of the depletion allowance between lessor and lessee, has allocated the allowance on that part of production represented by the amount of the bonus to the lessor; consequently, since the lessee cannot also take depletion on these same units, it must subtract this amount from its base for percentage depletion purposes. Internal Revenue Code of 1939, Section 23(m); Treasury Regulations 118 (1954 Code), Section 39.23 (m)-1(e)(5).

F. 2d 962 (C.A. 10th); *Canadian River Gas Co.* v. *Higgins,* 151 F. 2d 954 (C.A. 2d). See also *United States* v. *Dougan,* 214 F. 2d 511 (C.A. 10th); *Shamrock Oil & Gas Corp.* v. *Commissioner,* 35 T.C. 979, now pending on appeal to the Fifth Circuit. Not only have the courts rejected arguments that the Regulations are invalid; it has also been noted that the type of argument advanced by the present taxpayer amounts to saying that the lessee is entitled to a double depletion allowance—one through percentage depletion and another through cost depletion (amortization of lease cost, the lease bonus). See *Sunray Oil Co.* v. *Commissioner, supra,* at 966, 967.

To avoid the outstanding decisions, the taxpayer has argued that those decisions were invalidated by two sentences contained in this Court's opinion in *Burton-Sutton Oil Co.* v. *Commissioner,* 328 U.S. 25, 27, *i.e.,* "If they are capital investments to one, they are capital sales to the other. If they are rents or royalties paid out to one, they are rents or royalties received by the other". These sentences were contained in a preliminary portion of the *Burton-Sutton* opinion explaining the Court's reasons for granting certiorari and that case did not involve a lease bonus. Thus, the court below (Pet. B–2), like the trial court before it (Pet. A–7), was not convinced that the two quoted sentences changed the law as announced in the *Sunray Oil* and *Canadian River Gas* cases. For the same reasons which support that view, there is no merit in the taxpayer's assertion here (Pet. 6, 10–11) that the decision below is in conflict in principle with *Burton-Sutton.*

There also is no basis for the taxpayer's assertions of other conflicts in principle with decisions of this Court. Contrary to the taxpayer's statement (Pet. 10), *Burnet* v. *Harmel,* 287 U.S. 103, did not hold that a lease bonus is an advance royalty to the lessor. *Anderson* v. *Helvering,* 310 U.S. 404, is simply an application of the "economic interest" test for determining whether a sale occurred (see, *e.g., Commissioner* v. *Southwest Expl. Co.,* 350 U.S. 308), a test which was first enunciated in *Burnet* v. *Harmel, supra,* and *Palmer* v. *Bender,* 287 U.S. 551.

There is no real conflict between the decision below and that of the Fifth Circuit in *Lambert* v. *Jefferson Lake Sulphur Co.,* 236 F. 2d 542. That case involved the question whether the taxpayer, the owner of sulphur rights under a contract, was entitled to a deduction for fixed rentals payable periodically during the primary term of the agreement. The District Court held that the payments were not delay rentals but accepted the taxpayer's contention that they were excludible from gross income as being advance royalties. On appeal, the Fifth Circuit stated that the District Court "reached the correct conclusion on the grounds assigned by it as its basis" (*id.* at 546) but based its affirmance primarily on the entirely different ground that "the payments in question were in the nature of delay rentals" and therefore deductible as rent. In brief, the government's position was rejected on the ground that the payments were true rental payments rather than a lease bonus. Moreover, since the factual conclusion that the payments were delay rental payments was directly contrary to the District Court's

holding, it is apparent that the Fifth Circuit did not truly approve the basis of the District Court's decision.

The claim of conflict apart, the issue does not have sufficient importance to warrant review. The question presented is answered by long-standing Treasury Regulations, as the taxpayer concedes, and the taxpayer offers no ground for a holding that those Regulations are invalid. The argument that it is unfair to treat a lease bonus one way as to the lessor (as income) and another way as to the lessee (as a capital investment) is answered, as the Tenth and Second Circuits long ago recognized in *Sunray Oil* and *Canadian River Gas,* by the fact that it is not at all unusual for a payment to be a capital investment as to the payor and income as to the payee.

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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In the

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Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

REPLY TO BRIEF IN OPPOSITION

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REPLY TO BRIEF IN OPPOSITION

The Government concedes the anomaly of treating a bonus as a capital investment of the lessee for taxable "gross income" purposes and at the same time treating the bonus as an advance royalty for depletable "gross income" purposes.

Its answer is not to justify the merits of such a position but merely to state that this result "is required by long standing Treasury Regulations * * *." (Br. 2.) Petitioner submits that not only is this treatment itself anomalous but the unfairness of this anomaly is aggravated by the fact that these rules are not uniformly administered. See Pet. p. 17 and the Motion and Amicus Brief filed with the Court in the instant case by Ashland Oil & Refining Company.

The Government says that petitioner's position amounts to saying that the peitioner is entitled to double depletion. (Br. 3.) There is a doubling up of the depletion allowance *only* to the extent there is a doubling up of income subject to tax. Moreover, this Court has clearly rejected the notion that there can be only one depletion allowance for each barrel of oil. *Commissioner v. P. G. Lake, Inc.*, 356 U.S. 260 (1958), holds that the seller of a carved-out oil payment realizes ordinary income but subject to depletion. As the production pays the oil payment out, the purchaser also depletes the oil income. Thus, "double depletion" is allowed on the same barrel of oil when such barrel is taxed twice. As a matter of fact, this "double depletion" allowance was the basis of the petition for rehearing in the *Lake* case, which petition was denied by this Court. Accordingly, the Government's "double depletion" argument is without merit.

The Government says (Br. 4.) that *Burnet v. Harmel*, 287 U.S. 103 (1932), did not hold that a lease bonus is an advance

royalty to the lessor. This Court thought otherwise in *Anderson v. Helvering*, 310 U.S. 404 (1940), where it is stated:

> "Cash bonus payments, when included in a royalty lease, are regarded as advance royalties, and are given the same tax consequences. *Burnet v. Harmel*, 287 U.S. 103 * * *."

The Government is not convincing in its attempt to reconcile the conflict presented by the present case and the principles enunciated by this Court in *Burnet v. Harmel*, 287 U.S. 103 (1932), *Anderson v. Helvering*, 310 U.S. 404 (1940), and *Burton-Sutton Oil Co. v. Commissioner*, 328 U.S. 25 (1946). If bonuses, royalties, production payments, net profits interests, and working interests are all included in the pool of economic interests, as they indisputedly are, then the only possible result it to treat them alike. This is what *Burton-Sutton* is saying, based upon the Court's earlier holdings in *Burnet v. Harmel* and *Anderson v. Helvering*. This Court's statement in *Burton-Sutton* that if "they are rents or royalties paid out to one, they are rents or royalties received by the other," therefore, is more than a mere explanation for granting certiorari; it is a commitment to the consistent application of basic oil and gas tax principles. The above decisions of this Court require the bonus to be excluded from petitioner's taxable "gross income" as an advance royalty and the decision of the Court below clearly conflicts with these principles.

As to *Lambert v. Jefferson Lake Sulphur Co.*, 236 F. 2d 542 (5th Cir. 1956), the Government states there "is no real con-

flict" (Br. 4) and at the same time admits that in *Jefferson Lake* the District Court held the payments there involved should be excluded from gross income as an advance royalty, a holding which is in direct conflict with the decision of the Court below in the instant case. The Fifth Circuit expressly stated in *Jefferson Lake* that the District Court "reached the correct conclusion on the grounds assigned by it as its basis." Petitioner submits that this is plainly a holding and plainly presents a direct conflict between the Fifth Circuit and the Court below.

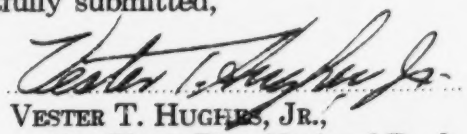
Judge Learned Hand, dissenting in *Canadian River Gas Co. v. Higgins*, 151 F. 2d 954 (2d Cir. 1945), answers the Government's contention that it is not unusual for a payment to be a capital investment to the payor and income to the payee. The Government does not and cannot escape the force of Judge Hand's reasoning, *viz.*, that the *character* of the payment does not change. Once characterized as an advance royalty, which it is to the lessor, it similarly is an advance royalty to the lessee.

The Government has offered no convincing argument on the merits, nor has it overcome the conflict between the decision of the Court below and the *Jefferson Lake Sulphur* case and between the decision of the Court below and principles enunciated by this Court.

Petitioner reiterates that, because of the recurring importance of this question and the need for uniform and fair

administration of the tax laws, this Court should grant the petition for a writ of certiorari.

Respectfully submitted,



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CERTIFICATE OF SERVICE

I, Vester T. Hughes, Jr., one of the attorneys for Murphy Oil Corporation, Petitioner herein, and a member of the Bar of the Supreme Court of the United States, hereby certify that on the 8th day of April, 1965, I served copies of the foregoing Reply to Brief in Opposition upon the Solicitor General, Department of Justice, Washington 25, D. C., by air mail, postage prepaid, and upon counsel of record who represented the United States of America, Respondent herein, in the court whose judgment is sought to be reviewed, in accordance with paragraph 2(a) of Rule 33 of the Rules of this Court.

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Respondent.

MOTION OF RICHARD A. FRELING FOR LEAVE TO FILE BRIEF *AMICUS CURIAE* AND BRIEF *AMICUS CURIAE* IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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Respondent.

MOTION OF RICHARD A. FRELING FOR LEAVE TO FILE BRIEF AS *AMICUS CURIAE* IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF APPEALS FOR THE EIGHTH CIRCUIT

I, Richard A. Freling, respectfully move this Court for leave to file the accompanying brief in support of the Petition for a Writ of Certiorari in this case as *amicus curiae*. The consent of the attorney for the Petitioner herein has been obtained, but the attorney for the Respondent herein has refused to consent to my filing a brief as *amicus curiae*.

I am an attorney in Dallas, Texas, engaged primarily in the practice of law relating to matters of Federal taxation. I represent various clients engaged in the oil and gas business, but I have not communicated with any of such clients regarding the pendency of the Petition for a Writ of Certiorari in this case nor my intention to file this motion or the accompanying brief. I do not represent any client having, to

my knowledge, any case pending before the Internal Revenue Service or any court involving the issue of law involved herein. I am undertaking to file the accompanying brief as an active practitioner interested in the development of this specific issue of law, and, because I have authored several articles on the subject, as an academician.

In particular, the court below in the instant case[1] cited a statement from my article, *Bonus Payments Through the Looking Glass*,[2] in support of its decision against Petitioner that *Burton-Sutton Oil Co. v. Comm'r.*, 328 U.S. 25 (1946) did not control the issue of law before the court. The quotation was taken out of context, and was employed by the Court of Appeals in reaching a decision completely contrary to the conclusions of my article.

The decisions of the Court of Appeals and the District Court continue to interpret the law erroneously, contrary to other decisions of this Court and to fundamental concepts of taxation. I therefore respectfully urge the Court to grant this motion, so that I may voice my position on this important point of law.

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[1] See Petition for a Writ of Certiorari filed herein, Appendix B-3.
[2] Prentice-Hall, Oil and Gas Taxes § 2027 (1962).

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Argument:

Respondent's regulations treat a bonus paid for an oil and gas lease inconsistently to the lessor and the lessee, thereby subjecting the lessee to an increased tax burden because he has expended his capital in the pursuit of profit. The lessee should be entitled to exclude a bonus ratably over the life of the lease for all purposes of Federal income taxation, or should not be required to exclude a bonus for any purpose. 2

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BRIEF OF RICHARD A. FRELING AS *AMICUS CURIAE* IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF APPEALS FOR THE EIGHTH CIRCUIT

By leave of this Court, I, Richard A. Freling, file this brief as *amicus curiae.*

INTEREST OF THE *AMICUS CURIAE*

My interest as *amicus curiae* is set forth generally in the motion which this brief accompanies. To reiterate, I have no direct interest in this case or any related or analogous case, and this brief is filed as an expression of my discontent, as an active practitioner and author, with the illogical

and totally unfair interpretation of the law espoused by Respondent and sustained by the courts below.

ARGUMENT

The assignment of an interest in an oil or gas property or lease, subject to the retention by the assignor of a continuing royalty, constitutes a lease or sublease for Federal income tax purposes under the decisions of this Court.[1] Any cash consideration paid to the "lessor" or "sublessor" represents a bonus which, in the hands of the recipient, is treated as advance royalty income, subject to an appropriate allowance for depletion. Although the characterization of a bonus as an advance royalty may, as an initial proposition, be open to criticism,[2] my concern is not with that characterization but with the persistent failure of Respondent to apply it consistently to both the recipient-lessor and the payor-lessee.

Respondent's regulations[3] provide that the lessee must capitalize the bonus as his basis for the leasehold estate. Nevertheless, the lessee must each year exclude from his

[1] *Burnet v. Harmel*, 287 U.S. 103 (1932); *Palmer v. Bender*, 287 U.S. 551 (1933). See also *Hogan v. Commissioner*, 141 F. 2d 92 (5th Cir. 1944); G.C.M. 22730, 1941-1 Cum. Bull. 214.

[2] Despite the fact that the lessor retains a continuing economic interest in the minerals in place, the cash consideration for the assignment of a defeasible fee or other estate in the remainder of the minerals in place might well have been categorized as capital gains to the assignor. In that event, the issue now involved in the Petition for a Writ of Certiorari could not exist. In other words, the lessee would not be compelled to exclude the bonus from his gross income in computing percentage depletion or for any other purpose.

[3] Reg. § 1.612-3(a)(3), IRC of 1954.

gross income for purposes of computing percentage depletion an amount equal to a ratable portion of the bonus,[4] the reason allegedly being that the lessor has already claimed depletion with respect to this income (*i.e.*, the advance royalties with which the lessor was charged). However, the regulations turn right around and deny the lessee the right to exclude the amount of the bonus for purposes of calculating his taxable income on the ground that the bonus is part of his leasehold basis which must be recovered only through deductions for depletion.

The regulations therefore penalize the lessee — require him to pay additional taxes — because (not in spite of, but because) he has made an investment (presumably with tax paid dollars) in pursuit of profit. The very statement of the result is so incredible, that one may reasonably wonder about the validity of the statement. Yet, the result under the regulations is demonstrable and irrefutable.

For example, assume that *A* and *B* are both independent oil operators, and that the income of both is taxed in the 50 percent bracket. *A* negotiates a lease on Blackacre, for which he pays a cash bonus of $100,000, and the lessor reserves a one-eighth royalty. *B* obtains a lease on adjoining Whiteacre without paying a bonus, and his lessor also reserves a one-eighth royalty. We may assume for purposes of our illustration that production from each lease over its life is $800,000; the expenses attributable to each lease are

[4] Reg. § 1.613-2(c)(5)(ii), IRC of 1954; Reg. 118, Sec. 39.23(m)-1(e)(5).

$100,000; percentage depletion exceeds cost depletion to *A* in each year; and the 50 percent of taxable income limitation on percentage depletion is never applicable. The taxable income of *A* and *B* over the life of the properties is as follows:

	A	B
Total Income from Production	$800,000	$800,000
Less: Royalty to Lessor	100,000	100,000
Lessee's ~~Lessor's~~ Gross Income from Production	700,000	700,000
Percentage Depletion ($700,000 [less bonus, if any] x 27½%)	165,000	192,500
Expenses	100,000	100,000
Taxable Income	435,000	407,500
Tax @ 50%	217,500	203,750
	203,750	
Difference in Tax	$ 13,750	

Of course, the facts set forth in the example are not likely to occur in such close tandem, so that the effect of the regulations becomes masked. However, it is clear that, as determined under the regulations, *A's* taxable income exceeds *B's* taxable income by the amount of depletion on the $100,000 bonus which *A* was required to exclude for purposes of that computation. It cannot be gainsaid, therefore, that *A's* taxes (and, indeed, the taxes of every lessee who pays a bonus) are greater than if he had not paid a bonus, *i.e.*, he is penalized taxwise for having invested his capital in the production of income. Viewed in this light, a reasonable argument

might be advanced that the regulations are unconstitutional as imposing a tax on capital, not the income therefrom.

In any event, it seems to me that the result produced by the regulations cannot be tolerated within our fundamental concepts of taxation. The regulations are wrong, and the decisions which uphold the regulations are wrong. With all due respect, the early courts which were confronted with this problem simply bogged down in the weight of their own logic,[5] and only Judge Learned Hand, dissenting in the

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[5] *Canadian River Gas Co. v. Higgins*, 151 F. 2d 954 (2d Cir. 1945); *Sunray Oil Co. v. Commissioner*, 147 F. 2d 962 (10th Cir. 1945); *Quintana Petroleum Co. v. Commissioner*, 143 F. 2d 588 (5th Cir. 1944). These courts began with the premise that the bonus represented the cost of the leasehold to the lessee and must therefore be capitalized as leasehold basis. Once this conclusion was accepted, the courts were trapped in the middle of the arguments which, on the one hand, preclude recovery of leasehold basis except through deductions for depletion, and, on the other hand, require the lessee to exclude from gross income the amount of income on which the lessor has claimed depletion.

The fallacy lies in the basic premise. This Court said in *Burton-Sutton Oil Co. v. Commissioner*, 328 U.S. 25 (1946) that, with respect to payments between lessors and lessees of oil and gas properties, "If they are capital investments to one, they are capital sales to the other. If they are rents or royalties paid out to one, they are rents or royalties received by the other." The Court of Appeals rightly quoted from my article *Bonus Payments Through the Looking Glass*, Prentice-Hall, Oil and Gas Taxes § 2027 (1962) to the effect that a capital investment to the payor is not necessarily a capital sale to the payee. However, the Court of Appeals stopped there, and thus missed the point entirely. This Court requires only that a bonus have a reciprocal identity in the hands of both the lessor and the lessee. It is an advance royalty received by the lessor and thus must be an advance royalty paid by the lessee. If the payment results in a benefit extending over several years, then the bonus should be capitalized as an accounting matter, but it should not be capitalized as or merged with basis for the leasehold estate. It should be capitalized as what it is: prepaid or advance royalties.

Canadian River Gas case,[6] correctly analyzed the law and pointed the way towards solution. More recently, the Tax Court[7] appears to have abdicated its responsibility in favor of the Congress, and the courts below in the instant case seem to have been swayed by the length of time during which the error in the regulations has gone uncorrected.

On the other side of the street stand the decisions in *Lambert v. Jefferson Lake Sulphur Company*,[8] which are in conflict with those of the courts below, and the decisions of this

[6] *Canadian River Gas Co. v. Higgins, supra* note 5 at 957, wherein it is stated:

> "The reason for this, as I gather, is that such a 'bonus' is payment in advance for units of gas, in which, although the lessee has the right to withdraw them in the future, the lease gives him no immediate interest. Conversely, the lessor does not part with any interest in the gas until the lessee withdraws it. These decisions thus put a 'bonus' on the same footing as current royalties, in spite of the fact that it is not apportioned to future withdrawals, and is not recoverable, if there are no withdrawals; and it is because it is upon that footing that it is income. The important thing to observe is that this consequence is a deduction from the rights which the lease creates.
>
> "The plaintiff merely asks that the lease shall be construed in the same way, when the lessee is taxed. It says that if a 'bonus' is 'advance royalties,' and a payment for units to be later withdrawn, which remain the lessor's while they are in situ, it must be 'advance royalties,' when the opposite party, the lessee, is taxed: that the rights created cannot vary as one looks through different ends of the same document. My brothers find it a sufficient answer to say that the same payment may be at once income to the payee, and a capital expenditure to the payor. That is true: for example, when a customer buys goods from a merchant, he may be making a capital expenditure, yet the merchant will receive income. Nevertheless, the legal effect of the transaction does not shift; the same contract is not construed to create one kind of right when the customer is to be taxed, and another when the merchant is. Yet that is what we must do here, if we are to escape the force of the decisions I have mentioned * * *"

[7] Shamrock Oil and Gas Corp., 35 T.C. 979 (1961).

[8] 236 F. 2d 542 (5th Cir. 1956), *aff'ing*, 133 Supp. 197 (D.C. La. 1955).

Court in *Burton-Sutton Oil Co. v. Commissioner*,[9] *Andersen v. Helvering*,[10] and *Burnet v. Harmel*,[11] the principles of which also require reversal of the instant case.

The real issue, in my opinion, is not whether the present regulations should be modified, but rather the correct basis on which such modification should be made. The alternatives are clear: (1) a lessee should be required and entitled to exclude the amount of a bonus paid for an oil or gas lease from his gross income for all purposes of Federal income taxation, or (2) a lessee should not be required to exclude the amount of a bonus paid for an oil or gas lease for any purpose.

As a corollary to the first alternative, the bonus exhaustion formula could be retained, but the bonus would be capitalized as something (*e.g.*, prepaid royalties) other than as basis for the lessee's leasehold estate. This would be consistent with the treatment of advance royalties to the lessor, and would not disturb other traditional oil and gas tax concepts. The bonus exhaustion formula would then dictate the amount which would be excluded from the lessee's gross income for all purposes. As a corollary to the second alternative, the total gross income subject to depletion by the owners of all the economic interests in the lease would be measured by the actual gross income from production plus the amount of the bonus. In other words, the income on which the lessor claims depletion would not be the same as, but would be in

[9] 328 U.S. 25 (1946).

[10] 310 U.S. 404 (1940).

[11] 287 U.S. 103 (1932).

addition to, the income on which the lessee claims depletion. Hence, there would be neither reason nor justification for requiring the lessee to exclude the amount of the bonus for purposes of computing his percentage depletion.

CONCLUSION

As *amicus curiae*, I urge the Court to grant the Petition for a Writ of Certiorari, and upon hearing of the case to reverse the decisions below and render judgment in favor of the Petitioners.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I, Richard A. Freling, *Amicus Curiae*, and a member of the Bar of the Supreme Court of the United States, hereby certify that on the .... day of March, 1965, I served copies of the foregoing Motion and Brief upon the Solicitor General, Department of Justice, Washington 25, D. C., upon counsel of record who represented the United States of America, Respondent herein, in the court whose judgment is sought to be reviewed, and upon counsel of record for Petitioner herein, all by depositing same in a United States Post Office, with first class (and airmail, where necessary) postage prepaid, addressed to such counsel at their respective post office addresses, and otherwise in accordance with the applicable rules of this Court.

.....

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1964

No. 899

MURPHY OIL CORPORATION, *Petitioner,*

v.

UNITED STATES OF AMERICA, *Respondent.*

MOTION OF ASHLAND OIL & REFINING COMPANY FOR LEAVE TO FILE BRIEF AS AMICUS CURIAE IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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Ashland Oil & Refining Company ("Ashland") respectfully moves this Court for leave to file the accompanying brief in support of the Petition for a Writ of Certiorari in this case as *amicus curiae*. The consent of the attorney for the Petitioner herein has been obtained; the consent of the attorney for the Respondent herein has not been obtained.

Ashland is a Kentucky corporation engaged in all phases of the petroleum industry including explora-

tion, production, transportation, refining and marketing. In more recent years Ashland has greatly increased its activities in the exploration and production phases of the business which involve the acquisition of oil and gas properties. Ashland has been and is greatly interested in the tax treatment accorded the payment of bonuses in the oil and gas lease transaction. Ashland has paid such bonuses, both to individual and corporate owners, and to the United States Government. Ashland, therefore, has a direct interest in the Petition for a Writ of Certiorari filed by the Murphy Oil Corporation.

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By leave of this Court, Ashland Oil & Refining Company hereby files this brief as *amicus curiae.*

INTEREST AND ARGUMENT OF THE AMICUS CURIAE

Ashland believes that it would be superfluous and unnecessarily consume the time of this Court to recite the authorities and to paraphrase the arguments presented in the Petition for Writ of Certiorari by the Murphy Oil Corporation.

Ashland fully concurs in the reasons offered by Murphy for granting the Writ. The income tax treatment of bonus payments in oil and gas lease transactions prescribed by the Internal Revenue Service is

contrary to the principles enunciated in the decisions of this Court, is pointedly inconsistent, and fundamentally unfair. Ashland is of the informed opinion that the tax treatment invoked against Murphy in this instance is not adhered to by a substantial segment of the taxpayers comprising the oil industry and that this treatment is not uniformly invoked by the agents of the Internal Revenue Service.

Ashland, like Murphy, submits that the recurring importance of the principle in the administration of the tax laws and the conflict of decisions of the lower courts and this Court and the Court of Appeals for the Fifth Circuit warrants review and a definitive adjudication of the issue presented by Murphy to this Court. Ashland, therefore, urges this Court to grant the Petition for Writ of Certiorari and after consideration of the case to reverse the decision of the Court of Appeals for the Eighth Circuit.

Respectfully submitted,

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Certificate of Service

I, Fred M. Vinson, Jr., one of the attorneys for Ashland Oil & Refining Company, *Amicus Curiae* herein, and member of the Bar of the Supreme Court of the United States, hereby certify that on the 1st day of April, 1965, I served copies of the foregoing Motion and Brief upon the Solicitor General, Department of Justice, Washington 25, D. C., upon counsel of record who represented the United States of America, Respondent herein, in the court whose judgment is sought to be reviewed, and upon counsel of record for Petitioner herein, all by depositing same in a United States Post Office, with first class (and airmail, where necessary) postage prepaid, addressed to such counsel at their respective post office addresses, and otherwise in accordance with the applicable rules of this Court.

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On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

PETITION FOR REHEARING

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In the

Supreme Court of the United States

OCTOBER TERM 1964

No. 899

MURPHY OIL CORPORATION,

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UNITED STATES OF AMERICA,

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On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

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PETITION FOR REHEARING

Pursuant to paragraph 2 of Rule 58 of the Rules of the Supreme Court, Petitioner hereby petitions for a rehearing

of the order of the Court denying the Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit in the above styled cause.

As set out in the Petition (Pet. 18) the identical issue involved in this case is also pending before the Fifth Circuit in *Shamrock Oil & Gas Corp. v. Commissioner*, 35 T.C. 979. In view of the Fifth Circuit's holdings in *Lambert v. Jefferson Lake Sulphur Co.*, 236 F. 2d 542 (5th Cir. 1956), and *Commissioner v. Gracey*, 159 F. 2d 324 (5th Cir. 1947), Petitioner believes that, in the *Shamrock* case, the Fifth Circuit will affirm the position that *Quintana Petroleum Co. v. Commissioner*, 143 F. 2d 588 (5th Cir. 1944) has been overruled; therefore, a direct conflict in the tax treatment of oil and gas bonuses will exist between the Fifth Circuit in the *Shamrock* case and the court below in the instant case. Moreover, in view of this conflict, it is reasonable to anticipate that the Government will seek certiorari in the *Shamrock* case.

The *Shamrock* case was argued before the Fifth Circuit on February 22, 1965, and a decision may be expected by late summer or early fall. Therefore, if the denial of the instant petition for a writ certiorari stands, Petitioner will be without a remedy if the Court subsequently hears the *Shamrock* case and sustains either Petitioner's primary or alternative position.

Petitioner therefore moves that the Court set aside its order denying the petition for a writ of certiorari in the

instant case pending the decision of the Fifth Circuit in *Shamrock Oil & Gas Corp. v. Commissioner.*

Respectfully submitted,

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Vester T. Hughes, Jr., certifies that he is one of the attorneys for petitioner, that the foregoing petition for rehearing is submitted in good faith and not presented for reasons of delay, and that such petition for rehearing is restricted to grounds not previously fully presented.

VESTER T. HUGHES, JR.,
Attorney for Petitioner.

CERTIFICATE OF SERVICE

I, Vester T. Hughes, Jr., one of the attorneys for Murphy Oil Corporation, Petitioner herein, and a member of the Bar of the Supreme Court of the United States, hereby certify that on the 12th day of May, 1965, I served copies of the foregoing Petition for Rehearing upon the Solicitor General, Department of Justice, Washington 25, D. C., by air mail, postage prepaid, and upon counsel of record who represented the United States of America, Respondent herein, in the court whose judgment is sought to be reviewed, in accordance with paragraph 2(a) of Rule 33 of the Rules of this Court.

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